BORROWING AS A PHASE OF WAR FINANCIERING

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Since the United States became an active belligerent many opinions have been expressed relative to the financial management of this war. I have tried to analyze these opinions in order to discover, if possible, the economic basis on which they rest. I have also followed the debates in Congress on finance bills, and have read the utterances of the Secretary of the Treasury, who, by virtue of his official position, ought to be the leader in financial opinion and the formulator of a comprehensive financial program. While the legislative outcome of all this writing and speaking does, on the whole, command a qualified approval, it fails, as it seems to me, to grasp the significance of the industrial side of war financiering. It is exclusively to this phase of the subject that I ask your attention.

Public and Private Credit Compared

My first remark is not so much critical as it is the expression of a neglected truism. Much of the gratuitous advice given to Congress rests on the implication that the rules of credit evolved from the study of ordinary business experience can be carried over and applied without modification to government borrowing in time of war. This, of course, is not true. Capital borrowed for commercial investment is a step in capital building; capital borrowed for war uses is a step in capital annihilation. The former adds a new source from which the fund of free capital may be filled; the latter not only prevents the opening of new sources, but it tends to dry up some of the sources from which free capital now flows. Any program for the financial management of a war that fails to recognize, and to act on, this truth, is bound to meet misfortune.

Again, in the case of private borrowing, it is the continued prosperity of a particular business that validates the underlying securities; in the case of public borrowing, it is the continued prosperity of all industries, regarded as a production unit, that

gives worth to government bonds. From this, also, the war financier may read a lesson.

But perhaps the most significant difference between the use of credit for investment and for war is found in the principle upon which reliance must be placed for the control of each. The commercial investment of capital is controlled by the expectation of personal profit and, consequently, all of the well established laws of business conduct may be used as tests for such an investment. This control and this test are absent when a government borrows money to meet the cost of war. It means the adjustment of credit contracts with a view to their ultimate results as well as their immediate success. This means the possibility, if not indeed the necessity, of a radical interference with the orderly procedure of an established market for capital. The selection of a rate of interest on a government bond, for example, does not so much depend on the ability of the government to sell its bonds, as it does on the industrial effect of the sale of bonds at the rate selected. The experience of an industrial promoter who holds in mind the making of a profit by a particular enterprise, is of slight importance for the solution of the task of carrying through the finances of a great war. A new set of industrial purposes and new conditions for the use of the machinery of credits are brought to the surface by the advent of a war. This is the first thought to which I desire to give expression.

THE NATURE OF THE WAR BURDEN

It is equally necessary to understand correctly the content of the war burden. This is not, as many seem to reason, the sense of deprivation that comes with the payment of money, whether the occasion of that payment is to fill a loan or to cover a tax. There is doubtless a psychological side to war financiering. A successful treasury policy must make proper use of the motives by which men are controlled when they deal in business affairs. But this does not mean that the industrial burden of a war is a mental state, or that the chief element in that burden can be spread over a period of time by the manipulation of credit instruments.

The burden of a war, correctly apprehended, consists in the use of the productive power of the country for unproductive consumption. When a nation declares war, it has turned its face towards

commercial bankruptcy. Its position is altogether like that of a railway that continues to operate even though it fails to maintain its property out of current revenues. This, of course, means, in the case of the railway, that the management borrows from its property; that capital is depleted to cover operating expenses; and it is only a question of time before such a practice will carry the property into the hands of a receiver.

This is equally true of the industry of the nation regarded as a collective business unit and from this statement one may read the task of the financier in time of war. It is for him to so control both the machinery of credit and the machinery of taxation that the productive power of the country may be used to make headway against unproductive consumption, and at the same time to hold under control those forces that tend to wreck the industrial organization by which that power is maintained. This is the gist of the problem of war financiering and every act of government, whether within the Treasury or without, that fails to test its merits by this rule is likely to prove to be an embarrassment to sound financiering.

This point of view is familiar to all students of finance but somehow it always needs to be "hammered in" when the occasion for a war program arrives. For that reason, I venture to try to express it in another way. The claim for production in time of war need be no greater than that claim in time of peace. The demands of government are doubtless increased and there is also an embarrassing change in the kind of things demanded; but this demand, if considerable, must result in the curtailment of ordinary peace demands. This means that the task of carrying through a great war involves a radical readjustment of established industries. It is the cost of this transition that constitutes the great, the acute, the immediate burden of the war—a burden none the less real because it is unrecorded on the books of the Treasury. This transition ought to be attained at the earliest possible moment, so that balance in market conditions may be restored and maintained notwithstanding the change in the character of current consumption. To assist in this transition, if not indeed to place it under guidance and control, is a peculiar service of credit financiering; and it is the recognition of this responsibility that ought to give a definite industrial purpose to public borrowing during the first and second

years of a great war. This, and this alone, will enable the financier to lay the foundation of a trustworthy program of treasury administration.

THE BEARING OF INDUSTRIAL CONDITIONS

Since the task of financing a war centers in the control of industrial conditions, the industrial situation at the outbreak of hostilities is of great significance. This remark applied to the business situation of last spring calls for three observations.

First. The foreign market for capital was closed. The United States had for two years been loaning work to Europe. England, France and Russia were still in the American market with large orders for war munitions and their inability to pay for goods received had so affected foreign exchanges that settlement with American capital became a necessity. Under such conditions the classical argument in favor of a loan policy at the outbreak of a war was no longer applicable. It was not possible for this country, last spring, to relieve the first stress on home industries by calling to its aid the workshops of foreign countries. It was not possible to wait, as might have been done if bonds could have been sold in the foreign market, for the law of supply and demand, working through an inflated market, to effect the necessary readjustments in industry. This, so far as I know, is a new situation in war financiering. Since the world became familiar with international credits, there never has been a war that involved practically all of the capital-building nations of the world.

The lesson to be read from this situation is not far to seek. The United States must rely on its own capital and on its own labor for carrying through this war; and the quicker this capital and labor are organized to produce what the war needs, the earlier will the industrial phase of the nation's finances be brought under control.

Second. The second fact in the present situation I do not profess to understand. Not only is the door closed to foreign borrowing, but the financial center of the world has been transferred to New York. This, at least, is said to be the case. It is referred to by responsible writers as a fact of great significance and as an element of strength in the financial situation of this country. This may perhaps be true, but it looks to me like an increased demand for American capital in addition to our current industrial and war

demands. It may mean, however, the flow of neutral capital to New York and possibly of selling United States bonds in the Orient, in South America and in the neutral countries of Europe. But I confess that I do not understand what this transfer of the financial center of the world to New York may mean, and let it pass as an important fact that should be analyzed and mastered by those who are responsible for the financial program on which this war is to be fought out.

Third. A third fact of importance in the industrial situation is that the outbreak of hostilities found this country in a condition of inflated and one-sided prosperity. Had the formulation of a financial program taken place in 1913, when business was relatively slack, the task of the financier would have been somewhat easier. Under such conditions reasonable taxation would have acted as a stimulant, and the expansion of government demands would have been regarded as industrial encouragement. It would have been possible, by a judicious use of public credit at normal rates of interest, to have assisted, if not to have forced, the beginning of an industrial transition from a condition of peace to a condition of war.

The practical suggestion that springs from the fact that in April last this country was in a condition of unhealthy prosperity pertains to the rate of interest that the first public loans should have borne. Of course, we who are on the outside do not know all of the considerations that led the administration to issue its first loan at $3\frac{1}{2}$ per cent and its second loan at 4 per cent. These considerations may have been non-financial in character; but, if a quick change in the industrial machinery of production is accepted as the prime test of a sound financial program for the first year of belligerent conditions, there is reason to believe that this result is retarded rather than hastened by an issue of public bonds at a rate of interest below the normal market rate. It is, however, of slight use to discuss this phase of the problem. The two liberty loans are accomplished facts. They are a new factor to be considered in the further financial conduct of this war. The manner of their industrial working is at present highly speculative. It is possible that the movement in capital resulting from them is along channels that will help rather than hinder the reorganization of the workers of this country on a war footing. Of the enthusiasm which they aroused there can be no question, and this fact at least is the

occasion for encouragement. But the making of a program adequate to meet the demands which this war is likely to impose is a task as yet unaccomplished.

A SUGGESTION

There is nothing new in the principles of the science of finance, but the application of these principles to ever changing conditions sometimes justifies the consideration of new expedients. It is from this point of view that I desire to say a word.

There are three facts respecting the conditions under which this war is being fought that impose unusual responsibilities on the administration. The first is the dependence of the allies on the United States for an adequate food supply; the second is the development of a sense of social justice which forbids the government to make use of market inflation for carrying through a drastic financial program; and the third is the remarkable growth of class interest as exemplified in the constant demands for increased wages.

The situation created by these three facts is serious. They make the task of financing this war a difficult one. Thus far, the administration has endeavored to meet these responsibilities by establishing an organization for food control; by attempting to control the minimum price and to execute contracts on the basis of analyzed costs; and by accepting the financial liability for the payment of wages in order to keep industries going. These attempts, also, like the issue of the liberty loans, must be regarded as elements in the present situation, so quickly do ideas crystallize into conditions. The suggestion which I wish to make is that this effort on the part of the government to control the food situation, to adjust prices for munitions of war, and to pay wages which will keep the wheels of industry turning, cannot be carried on successfully each independently of the other; nor can any of them be accomplished unless they are made to correlate with the issue of bonds and the collection of taxes in a comprehensive, consistent and adequate treasury policy. These tasks are, from their nature and because of their industrial significance, a part of the task of financing a war.

It is possible to make this suggestion a little more concrete. Consider, for example, the problem of food supply. Nothing will be

accomplished by the declaration of a minimum price, or by an attempt on the part of the federal government to out-speculate the speculators. If anything effective is to be accomplished along this line it is essential that the ordinary considerations of commercial profits should be brought into play under the direction of a public purpose. Last spring a special effort was made to induce farmers to raise potatoes. The farmers of Michigan expressed themselves as willing to plant potatoes provided they were guaranteed a normal profit on the planting. They asked the guarantee of a maximum price or of a price adjusted to an analysis of cost. This the government was unwilling to do. According to the premise laid down in this paper the government should have guaranteed the price and have covered the guarantee by an issue to the individual farmer, in case of accruing liability, of a 5 per cent bond. Assuming this to have been done, not only in the case of planting potatoes but in every other crop the production of which in adequate amounts is essential for carrying on this war, and assuming that the direction of agricultural planting had been sought under the guidance of the administration, not only would the bonds have been placed where, from the political point of view, they would do the most good, but the industrial problem, so far as war financiering is concerned, would have been solved for the industry of agriculture. Suggestions for the administration of such a project may be found in the way France manages her tobacco monopoly.

The same procedure could be followed with factories that furnish the government with war supplies. A certain portion of the amount that the government must engage to pay (perhaps an abnormal profit, who can tell?) could be covered by government bonds. This suggestion is especially pertinent in the case of the building of new factories to meet the new war demands. In such cases, the uncertain element is the depreciation in the value of the investment when the war draws to a close. It is the fear of this loss that retards the outswing of new investments for producing what the government needs. Eight per cent current profit, with the possible loss of a 100 per cent depreciation in two years due to obsolescence, is not an attractive outlook. It is a reasonable proposition, in order to encourage the investment of private capital in war production, for the government to promise to reimburse investors for such loss of capital as they may sustain, and the easiest

way of covering this loss is by the issue of bonds to factory owners equal to the depreciation of obsolescence. By this means, the immediate necessity of ready money collected through taxes would be reduced; and this, as every student of finance knows, is the only justification of the use of public credit.

The suggestion here submitted might be used, also with good advantage, in the treatment of wage adjustments. If the government must guarantee wages in order to keep industries going, it would be highly advantageous for such guarantee to be covered by the use of public credit. The idea of partnership between the government and certain industries during the continuance of the war, would, by this expedient, be extended to the great body of industrial workmen. The difficulties, as well as the advantages of this plan, lie entirely on the surface, and for this reason I do not venture at this time to consider the details of the suggestion.